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The profit and loss account – major tool for the analysis of the company's performance

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Abstract

The level of results obtained by an enterprise represents, for any manager, a way to measure efficiency.
Recorded results are noted in the Profit and Loss Account that explains how they are obtained for each activity, and help to make decisions at management level in order to coordinate the whole business activity. This account represents the financial statement that allows highlighting partial results of the three main activities (exploitation, financial and extraordinary) as well as whole results.
The structure of this account allows money stocks accumulation to be released in order to fulfill the compensatory function of future financial factors and inputs, so called intermediate management balances.

Keywords: Profit and loss account, performances, intermediate management balances, added value, exercise result;

1. Introduction

Analysis of economic and financial enterprise performance allows development of judgments and appreciations on activity results and their correlations with the financial structure and its solvency.
The concept of performance, from enterprise prospective, means "success" or "achievement" as a management result. It can be defined and quantified with the help of indicators and rated criteria (profit, profitability, growth factor, social climate, brand image). The ranges of indicators that characterize enterprise performances make it hard for analysts to do a selection and to rank them accordingly, in order to reflect a faithful achievement of enterprise performance.
From the multitude of indicators, we have studied those belonging to Profit and Loss Account , especially the intermediate management balances.

2. Source information used to analyze results

In order to maintain and develop enterprises we have to perform efficiently in today's' market economy, thus generating profit.

Profit or Income, is the money expression of gain as an activity result, and the main idea to generate profit is a lucrative economic activity. The level of results represents for any manager a way to measure efficiency. Results are reflected by Profit and Loss Account that explains how they are obtained for each activity type, and how decisions are made at management level in order to coordinate the entire firm activity.

The main aspects of performance analysis are as follow:

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1. Overall performance analysis based on Profit and Loss Account ;
2. Financial performance analysis based on rates.

Overall performance analysis based on Profit and Loss Account

The Profit and Loss Account allows tracking enterprise activity carried on types of activity, over a period of time, usually during the financial year. In order to achieve company's goal the activity developed is reduced to acquisitions, payments, production, sales and cashing, thus influencing the results account. Each of these activities belongs to a net result obtained from a financial plus at each activity level.

Profit and Loss Account sorts profit and expenses by activity: exploatation activity, financial activity, extraordinary activity. This account represents a financial statement that allows highlighting whole and partial results. With its help, we can explain the different stages of how exercise result it is established, allowing us to draw some conclusions regarding the level of economic performances over a period of time.

During the development of economic theory, there were two models of Profit and Loss Account : French model and Anglo- Saxon model.

The French model is characterized by**:**

- The concept of production including the sold one, the stocked one and the capitalized one;

-the nature of expanses. This structure of expanses allows establishing intermediate management balances and highlights value division among enterprise partners.

The Anglo-Saxon model has the largest applicability**:** USA, Great Britain, Canada, Holland and Japan; and it is different because:

- It is based on sales as a sole source of income;
- Expanses are classified by functions: production (costs), distribution, administrative function, financial and other expenses.

Unlike the French model, the Anglo-Saxon model does not use notions like: capitalized production, because production costs go directly to assets, stocked production because production costs of unsold goods go straight to stocks value. This practice is based on the principle that wealth created by company is generated by selling the production.

In addition, this model is based on market value of assets, cash flow being the main indicator of economic and financial analysis. As a result, the output, benefit, gross surplus of exploitation is considered "simple intellectual evaluations of potential earnings"[†].

The different way to structure expenses (by nature- French model, by functions- Anglo-Saxon model) enforces a different procedure to draw up the Profit and Loss Account .

So, while the French model uses as the main source of information for the Profit and Loss Account , financial accounting, the Anglo-Saxon model uses as main source of information management accounting, thus allowing establishing sales costs based on identifying direct and indirect costs, and their allocation.

As a conclusion, we can paraphrase a well-known author that states, "American economists' math is different from ours, where we put period they put comma".

In Romania, the structure of Profit and Loss Account , according to OMFP 3055/2009 for Accounting Regulations in congruence with European Directives, is as follows:

1. Net turnover
2. Variations of finished stocks and in- process stocks
3. Capitalized production made by company
4. Other operating income
5. a) Expenses with raw materials and consumables
b) Other external expenses
6. Human resources expenses:
a) Wages and allowances
b) Social security's expenses, with distinct mentioning of retirement benefits
7. a) Value adjustments regarding tangible and intangible assets

[†] M. Petcu (2009), Economic and financial analysis of the enterprise, Economic publishing, Bucharest, pg. 315

b) Value adjustments regarding current assets, if they exceed the value adjustments that are normal in the entity
8. Other operating costs
9. Income from participating interests, with separate indication of those derived from affiliated entities
10. Income from investments and loans belonging to current assets, with separate indication of those derived from affiliated entities
11. Other interest receivable and similar income, with separate indication of those derived from affiliated entities
12. Value adjustments regarding financial assets and investments held as current assets
13. Interests to pay and similar expenses, with separate indication of those derived from affiliated entities
14. Profit or loss from current activity
15. Extraordinary income
16. Extraordinary expenses
17. Profit or loss from the extraordinary activity
18. Corporate tax
19. Other taxes
20. Profit or loss of financial exercise.

Structure analysis of Profit and Loss Account reveal similar aspects with the French model, but also with similar aspects from the Anglo-Saxon model.

Similar to the French model, the Profit and Loss Account in Romania allows:

- determine exploitation result, financial result and extraordinary one;
- Highlighting in this account the adjustment made to the value of tangible and intangible assets, which makes easier to evaluate the economic asset of the enterprise, the estimation and interpretation of asset structure rates as well as its solvability

Similar to the Anglo-Saxon model, the new Profit and Loss Account used in Romania:

- Deals with elements like compensation, donation, disposal of assets considered exceptional in the French system, affiliated to common activity, which determines a different content of exploitation result compared to the one in the French system;
- Provides exploitation results according to OMFP 3055/2009 after the following pattern:
  1. Net turnover
  2. Sold goods and services cost (3+4+5)
  3. Base activity expenses
  4. Auxiliary activity expenses
  5. Indirect production expenses
  6. Net Turnover gross result(1-2)
  7. Selling expenses
  8. Administrative expenses
  9. Other exploitation expenses
  10. Exploitation result (6-7-8+9)

Also, in Romania, the Profit and Loss Account structure allows:

- Determining exploitation result, financial and extraordinary result- derived from calamities , expropriation;
- Distinct highlighting of tangible and intangible assets' evaluation, which makes easier to evaluate the economic asset of the company, the estimation and interpretation of asset structure rates as well as its solvability.

Advantages and disadvantages of the two models:

1. From the point of view of Profit and Loss Account information, have advantages as well as disadvantages:

- The Anglo- Saxon system appreciates functions and their management quality, without giving information regarding resource expenses and how surplus is distributed,
- The French system points out resource expenses according to their nature and allows payment for all participants to company activities;
- This type of account does not provide information regarding the functional analysis of the enterprise;

2. from a unitary data point of view and complex calculus:

- The main indicator of the French system is exercise production, which is complex (includes sold production, stored one and capitalized one) and inconsistent to evaluate (sold production is expressed by selling prices, while stored one and the one capitalized are expressed by production costs).The financial analyst uses this model in order to show how efficient are de production expenses, to appreciate some partial results indicators that have economic and financial significance (intermediate management balances).

- having an income from selling goods is the main thing for the Anglo-Saxon model, and so, the resulted expenses; this model has the advantage of a simple indicator evaluation, unitary expressed.

Because the two models have many disadvantages, we have to adopt a new structure for the Profit and Loss Account that has as reference the sold production and would allow sorting expenses by their functions as well as nature.

3. Analysis of Profit and Loss account - French model similarities

The Profit and Loss Account used in Romania and in the French systemallows us to determine intermediate management balances which represent indicators that highlight the stages of formation of the exercise result and constitutes a useful method of the decisional process to analyze income and expenses structure by their nature.

The main intermediate management balances are:

- Commercial margin;
- Exercise production;
- Gross surplus of exploitation;
- Exploitation result;
- Current result.

Intermediate management balances provide information that constitutes base for appreciation for the level of activity and surpluses released by the enterprise.

4. Analysis based on intermediate management balances (I.M.B.)

Intermediate management balance represents a profitability instrument, based on financial accounting, and also an alternative way to present information from the results account.

The structure of the Gain and Loss account, in to three activities(exploitation, financial, extraordinary) allows releasing potential stocks of money, destined to fulfill a paying function for the financial and production factors, called intermediate management balances(IMB), as follows:

1). Commercial margin: is an indicator used for describing the selling activity, even if the firm has only commercial or production activities (in this case it refers to the activity that belongs to its commercial function). The calculus formula is:

MC = Income from selling goods (account 707) – Cost of sold goods (account 607)

Income is evaluated at selling price without taking into consideration discounts given after sale, and costs represent the value of purchase, excluding discounts received after invoices are issued. The positive value of commercial margin indicates recovery of amounts invested in the purchase of goods as well as delivery of surplus to pay the other foreign or domestic factors involved in the company's activity.

A negative commercial margin indicates an unfavorable situation for the company, meaning that investments made for purchasing haven't been recovered yet, thus influencing the increase of stocks of goods.

In order to analyze the commercial margin it is recommended to analyze indicators value as well as their dynamic. Based on the balance methodology, the development of commercial margin is influenced by the development of income from selling goods and the cost of sold goods as follows:

AMC = A Income from selling goods (account 707) – A costs of sold goods (account 607)

Increasing revenues from selling goods is a favorable situation for the company while their decrease is unfavorable for the company (development of income may lead to an analysis presented in section 2.3.).

The cost of sold goods represents a reversed indicator towards commercial margin, so a positive development results in a decrease of commercial margin (negative situation), and its reduction leads to an increase of commercial margin (positive situation).

2*). Exercise production*: it's characteristic for the activity production and includes sold value production, variation of finished goods and semi-products, as well as assets production (tangible and intangible elements). In addition, this indicator highlights the dimension of commercial activity in an enterprise both with clients, through sold and stocked production, as well as with its self through asset production. This indicator is more specific to industrial units, measuring the whole volume of established activity, including value of goods and serviced "made" by enterprise to be sold, stocked or used for its own needs.

Evaluation for both tangible and intangible assets is made at cost production level for industrial companies, and it is formed out of turnover plus stocked and asset production.

If industrial companies have disparities between production moment and billing time, as well as significant values of stocked and asset production than exercise production gives a more faithful image of company activity than the turnover. Still, because this indicator is made out of inconsistent elements (some evaluated at selling price, some at cost production) and the method of stocks evaluation may modify the result, exercise production as a volume indicator needs further explanations.

Calculus formula for the indicator:

QE = Value of sold production (accounts 701 to 708) + Variation of stocked production (account 711) +Income from assets production (accounts 721 and 722)

Analyzing the indicator with balance sheet method is as follows:

ΔQE = Δ Value of sold production (accounts 701 to 708) + Δ Variation of stocked production (account 711) + Δ Income from assets production (accounts 721 and 722)

Further, the value of exercise production can be analyzed the same way:

Value of sold production = Income from selling finished goods (account 701)
+ Income from selling semi-products (account 702)
+ Income from selling residual goods (account 703)
+ Income from work performed and services rendered (account 704)
+ Income from studies and research (account 705)
+ Income from royalties, management and rental locations *(account 706)*
+ Income from selling merchandise (account 707)
+ Income from different activities (account 708)

So:

ΔValue of sold goods= Δ Income from selling finished goods
+ ΔIncome from selling semi-goods
+ Δ Income from selling residual goods
+ Δ Income from work performed and services rendered
+ Δ Income from studies and research
+ Δ Income from royalties, management and rental locations
+ Δ Income from selling merchandise
+ Δ Income from different activities

3). Added value *means* "plus of wealth exceeding intermediate consumption from third parties, through capitalization of own economic resources".

It can be computed in two ways:

- Subtractive method:

$Qa = Qe - Ci$

Where: Qa – added value
Qe – exercise production
Ci – intermediate consumption from third parties

another variation of the method is based on:

$Qa = MC + Qe - Ci$

Where: MC – commercial margin
C_i - intermediate consumption from third parties (accounts from groups 60, 61, 62, excluding account 607)

- Additive method:

Q_a *= Salaries expenses + Social security expenses +Amortization + Provisions+ Tax expenses (turnover tax exclusive) ++ exploitation result + financial expenses*

4). *E*xcess (deficit) of gross exploitation measures the effective use of capital economic, value added by the economic capital.

Calculus formula of EGE:

EGE = Q_a + Operating subsidies - *Tax expenses, taxes and similar – Staff expenses*

Where: *Qa* – added value

If the indicator value is negative we can talk about a deficit of gross exploitation.

This indicator is not influenced by company policies regarding amortization and forming provisions; also, he is not affected by financial operations or extraordinary operations. For these reasons EGE is very important in analyzing firm activity. EGE analysis can be made by several methods one them being the balance sheet method:

*Δ*EGE = *Δ*Q_a + *Δ Operating subsidies – Δ Tax expenses, taxes and similar –Δ Staff expenses*

5). Exploitation result – it is an indicator that evaluates economic profitability of a company. When exploitation result is positive we have profit, and when it's negative we have loss.

RE = RBE + (Income from operating provisions – (Amortization and operating provision expenses+
+ other operating income Other operating expenses)

Or

RE = Operating income – Operating expenses

6). Current result – measures profitability for the company's' entire operating and financial activity.

RC = RE + (Financial income – Financial expenses)

RC doesn't take into consideration fiscal policy; it is an indicator that considers the normal activity of the company.

7). Net result – expresses the absolute size of financial profitability that will be paid to stock holders. This net profit must be sustained by real amount of money, or else it will be just a financial potential.

Rnet = RC ± Rextra. – Profit tax

6. Conclusions:

The main data source for evaluating company results is Gain and Loss account. This account, also called the Results account is a synthetic accounting document that measures company activity during a period of time. It highlights flows of value that help increase or decrease the wealth of a company for a certain amount of time.

During this study, we have analyzed the French model of the Gain and Loss account, as well as the Anglo-Saxon one, and their main characteristics, we have identified the advantages and disadvantages of the two models, as well as the similarities had with the Romanian account.

We have exemplified the ***calculus of intermediate management balance*** *that represents "yet another way to present the Gain and Loss account, without making a complex economic and financial analysis*[‡]*.*

This suggests another way to group income and expenses as well as the forming mechanism of main indicators for performance and results. Although Romanian regulations do not refer to these balances, they can be considered a way to analyze the structure of company income and expenses, considering a useful process for decision making, that they are classified in groups.

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